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No. 80-2211

In the Supreme Court of the United States

OCTOBER TERM, 1981

SMITH BARNEY, HARRIS UPHAM & CO., INC.,
PETITIONER

v.

WENDEE HENRICKSEN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether a securities broker-dealer firm is subject to liability under the doctrine of respondeat superior for the fraudulent conduct of its employee in violation of Section 10(b) of the Securities Exchange Act.

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This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

Petitioner Smith Barney, Harris Upham & Co., Inc. ("Smith Barney") is a broker-dealer firm registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (Pet. 4). Respondent Wendee Henricksen brought this action in the United States District Court for the Eastern

District of Wisconsin against Smith Barney and her former husband, George Henricksen, who was an employee of the firm, to recover losses sustained as a result of Mr. Henricksen's fraudulent conduct in handling her discretionary securities account. Mrs. Henricksen alleged that Mr. Henricksen was liable for violations of Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5, promulgated thereunder (Pet. App. D-1), and that Smith Barney also was liable for her losses both under the controlling-person provision of Section 20(a) of the Securities Exchange Act, 15 U.S.C. 78t(a), and under the common law doctrine of respondeat superior.[1]

The district court, after a non-jury trial, held Mr. Henricksen liable for (1) his wife's trading losses from unauthorized options trading; (2) brokerage commissions and interest expenses incurred by her as a result of the unauthorized trading; and (3) amounts that Mr. Henricksen had converted by selling securities in her account, endorsing Smith Barney's checks representing the proceeds of the sales, depositing those checks in the couple's joint bank account, and subsequently withdrawing a like amount in cash (Pet. App. A-7). With respect to Smith Barney, the trial court rejected the claim that the firm was liable, under the doctrine of respondeat superior and under Section 20(a) of the Securities Exchange Act, for all losses caused by the wrongful conduct of its employee (Pet. App. A-7). The court ruled, however, that the firm was liable to Mrs.

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[1] The complaint also alleged claims based on state common law and certain rules of the New York Stock Exchange and the National Association of Securities Dealers, Inc. (Pet. App. D-1).

Henricksen for the commissions and interest expenses she had incurred in connection with the options trading in her account, because Smith Barney would be unjustly enriched if it were allowed to profit from Mr. Henricksen's fraudulent conduct (*ibid.*).

The court of appeals reversed, concluding that Smith Barney was liable for all categories of damages. In the view of the court, the firm was liable under Section 20(a) of the Act, based on its failure adequately to supervise the account, for respondent's trading losses, for her commission and margin expenses, and for the conversion of funds from her account after the date the firm should have conducted a full review of her account as required by its internal procedures (Pet. App. A-13). The court of appeals further concluded that under the common law doctrine of respondeat superior Smith Barney was liable for all of the funds converted from Mrs. Henricksen's account, not just those converted after a review should have occurred (Pet. App. A-15).

DISCUSSION

The decision of the court of appeals applying the doctrine of respondeat superior to sustain liability under the federal securities laws does not conflict with any decision of this Court and is in accord with the prevailing view of the courts of appeals. Nevertheless, because of the importance of the doctrine of respondeat superior in providing investors a means of redress for losses incurred as a result of violations of the federal securities laws and because of a conflict among the circuits, we believe that this case warrants review by this Court.

1. Respondeat superior is a common law principle of secondary liability and generally "summarizes the

doctrine that a master or other principal is responsible, under certain conditions, for the conduct of a servant or other agent * * *."[2] A common application of that doctrine is the liability of an employer for a tort committed by its employee while acting within the scope of his employment,[3] or for a misleading statement made by an employee or other agent with actual or apparent authority.[4]

The applicability of respondeat superior to Section 10(b) violations rests upon the authority of the federal courts to look to fundamental common law principles when enforcing federally created rights, when such principles are necessary to effectuate the congressional purpose. This is particularly true in corporate litigation, a field in which common law agency principles, including the doctrine of respondeat superior, have long been utilized by the federal courts in fashioning remedies under various federal statutes. See *United States* v. *A & P Trucking Co.*, 358 U.S. 121, 125 (1958) (Motor Carrier Act); *New York Central & Hudson River R.R.* v. *United States*, 212 U.S. 481, 493 (1909) (Elkins Act); *United States* v. *Hilton Hotels Corp.*, 467 F.2d 1000, 1004 (9th Cir. 1972), cert. denied, 409 U.S. 1125 (1973) (Sherman Act). In *Gleason* v. *Seaboard Air Line Ry.*, 278 U.S. 349, 356 (1929), this Court, in applying the doctrine of respondeat superior in a diversity case, observed that "few doctrines

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[2] Seavey, *Speculations as to "Respondeat Superior,"* Harvard Legal Essays 433 (1934).

[3] *Restatement (Second) of Agency* § 219(1) (1958).

[4] *Id.* at §§ 257, 261.

of the law are more firmly established or more in harmony with accepted notions of social policy than that of the liability of the principal without fault of his own."

That agency principles are required to effectuate the congressional purpose embodied in Section 10(b) is demonstrated by the language of the statute. Section 10(b) makes unlawful fraudulent conduct by any "person," a term defined to include "company."[5] Since a corporation or other company can act only through its employees, the liability of such an entity for violations of Section 10(b) is necessarily based upon, and Congress must have intended the utilization of, common law principles traditionally employed by courts to hold corporations and other entities liable for the acts of their agents or employees. See *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975).[6] Moreover, as the Fifth Circuit recently commented, "[i]t is consistent with

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[5] Section 3(a)(9) of the Securities Exchange Act, 15 U.S.C. 78c(a)(9); see also 1 U.S.C. 1.

[6] In *United States* v. *A & P Trucking Co., supra*, 358 U.S. at 124, this Court held that a partnership may be held criminally liable for "knowingly" and "willfully" violating provisions of the Motor Carrier Act which proscribe certain conduct by any "person," a term defined by the Act to include partnerships. In that case, this Court rejected the argument that a partnership cannot be criminally liable since a partnership, as opposed to its individual partners, cannot act with a specific intent. In so doing, this Court stated (*id.* at 125):

> But the same inability to act *in fact* is true, of course, with regard to corporations and other associations; yet it

the remedial purpose of the federal securities acts" to require the employer to pay damages to its employee's victim when the employer "provides an employee with the means to carry out fraudulent practices * * *." *Paul F. Newton & Co.* v. *Texas Commerce Bank*, 630 F.2d 1111, 1118-1119 (5th Cir. 1980). This is particularly true in the context of the securities brokerage business where investors open accounts with the firm itself—as Mrs. Henricksen did—and they rely not only on the ability and integrity of the employee, but also, and in many cases primarily, on the reputation of the brokerage firm, enhanced by nationwide advertising. Indeed, so well established is the application of agency principles in corporate litigation under Section 10(b) and Rule 10b-5, that, in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 146-149 (1972), this Court imposed liability on a bank for the fraudulent conduct of its employees with only the terse statement "[t]he liability of the bank, of course, is coextensive with that of [its employees]." *Id.* at 154.

2. The decisions of the courts of appeals lack unanimity on the issue of whether respondeat superior is an appropriate basis for secondary liability under the federal securities laws. The prevailing view among the federal courts, exemplified by decisions of the United States Courts of Appeals for the Second, Fourth, Fifth, Sixth, Seventh and Tenth Circuits, is that respondeat superior may be utilized to hold employers liable for the fraudulent conduct of their employees in violation of provisions of the federal

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is elementary that such impersonal entities can be guilty of "knowing" or "willful" violations of regulatory statutes through the doctrine of *respondeat superior*.

securities laws.[7] The Court of Appeals for the Ninth Circuit, on the other hand, has held that agency principles such as respondeat superior are not applicable and that an employer's liability for violations of the Securities Exchange Act must be determined solely under the controlling-person provision of Section 20(a) of that Act. *Zweig* v. *Hearst Corp.*, 521 F.2d 1129, 1132-1133 (9th Cir.), cert. denied, 423 U.S. 1025 (1975); *Christoffel* v. *E.F. Hutton & Co.*, 588 F.2d 665, 667 (1978). The Court of Appeals for

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[7] See, *e.g.*, *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); *SEC* v. *Management Dynamics, Inc.*, *supra*, 515 F.2d at 812-813; *Johns Hopkins University* v. *Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970); *Paul F. Newton & Co.* v. *Texas Commerce Bank*, *supra*, 630 F.2d at 1118-1119; *Holloway* v. *Howerdd*, 536 F.2d 690, 694-695 (6th Cir. 1976); *Fey* v. *Walston & Co.*, 493 F.2d 1036, 1052 (7th Cir. 1974); *Carroll* v. *First National Bank of Lincolnwood*, 413 F.2d 353, 358 (7th Cir. 1969), cert. denied, 396 U.S. 1003 (1970); *Kerbs* v. *Fall River Industries, Inc.*, 502 F.2d 731, 741 (10th Cir. 1974).

Contrary to petitioner's contention (Pet. 9), *Carpenter* v. *Harris, Upham & Co.*, 594 F.2d 388 (4th Cir.), cert. denied, 444 U.S. 868 (1979), did not overrule the prior position of the Fourth Circuit. In *Carpenter*, the plaintiff sought to hold a brokerage firm liable for the conduct of its registered representative occurring *after* the representative left the employment of the firm (*id.* at 390) and thus the court did not reach the issue of the applicability of respondeat superior principles. Nor does *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968), represent a rejection of respondeat superior liability by the Eighth Circuit. The *Myzel* court did not consider the applicability of respondeat superior principles since the case did not arise in the employment context and the court found, on the facts of that case, that the defendants were liable under Section 20(a). 386 F.2d at 738. See *Zweig* v. *Hearst Corp.*, *supra*, 521 F.2d at 1132.

the Third Circuit has adopted an intermediate position that precludes the general application of agency principles under the federal securities laws except in cases involving broker-dealer firms or accounting firms, which, in the court's view, are under a strict duty of supervision and, therefore, are properly subject to respondeat superior liability.[8]

3. Contrary to petitioner's argument (Pet. 11), respondeat superior liability is not inconsistent with the statutory good faith and non-inducement defense provided under the controlling-person provision in Section 20(a). That Section was intended to supplement rather than curtail the common law liability of employers for the fraudulent acts of their em-

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[8] See *Sharp* v. *Coopers & Lybrand*, 649 F.2d 175, 185 (1981), petition for cert. pending, No. 81-433; *Rochez Brothers* v. *Rhoades*, 527 F.2d 880, 886 (1975). The commentators are likewise split on whether vicarious liability may be imposed for violations of the federal securities laws under the doctrine of respondeat superior. Compare Reininger, *Exclusive or Concurrent—The Role of Control and Respondeat Superior in the Imposition of Vicarious Civil Liability on Broker-Dealers*, 9 Sec. Reg. L. Rev. 226 (1981); Comment, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 Calif. L. Rev. 1513 (1981); Comment, *Secondary Liability of Controlling Persons Under the Securities Acts: Toward an Improved Analysis*, 126 U. Pa. L. Rev. 1345 (1978) (favoring application of respondeat superior); with Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Calif. L. Rev. 80 (1981); Comment, *A Comparison of Control Person Liability and Respondeat Superior: Section 20(a) of the Securities and Exchange Act*, 15 Calif. W.L. Rev. 152 (1979) (opposing application of respondeat superior). The American Law Institute's *Federal Securities Code* would preserve the applicability of agency principles. See ALI, *Federal Securities Code* § 202(86)(C), and Comment 3(b) to § 1724 (1980).

ployees. The controlling-person provisions of the securities laws were enacted

> to address the specific evil of persons seeking to evade liability under the acts by organizing "dummies," that, acting under their control, would commit the prohibited acts.[9]

Thus, "[the legislative] history does not reflect any congressional intent to restrict secondary liability for violations of the acts to the controlled persons formula * * *." *Paul F. Newton & Co.* v. *Texas Commerce Bank, supra*, 630 F.2d at 1118. There is no suggestion in the legislative history that Congress intended in 1934 to sweep away sub silentio the well-established doctrine of respondeat superior, which this Court in *New York Central & Hudson River R.R.* v. *United States, supra*, 212 U.S. at 494, described as "in the interest of public policy." Rather, Section 20(a) was intended to impose liability on controlling persons such as controlling shareholders or corporate officers, who would not be liable under

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[9] *Paul F. Newton & Co.* v. *Texas Commerce Bank, supra*, 630 F.2d at 1118. Although Section 20(a) on its face appears to apply to the employment or agency situation since the employer may be said to "control" its employee, the legislative history indicates that Congress did not enact that Section for the purpose of dealing with the employer-employee relationship. In describing the provision that eventually became Section 20(a), Thomas C. Corcoran, a spokesman for the drafters of the 1934 Act (see *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202 (1976)), testified: "The purpose is to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section." *Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.) Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 6571 (1934).

respondeat superior because they are not the actual employer. Section 20(a) expanded common law notions of secondary liability and, in so doing, created specific defenses available only to those who, under common law respondeat superior, would have faced no liability at all.

Far from undercutting the statutory scheme, the availability of relief against employers based on respondeat superior renders that scheme both equitable and coherent. For example, in the securities brokerage firm situation, the employee who personally committed the violation would be primarily liable to the customer, based on proof of that employee's own acts or omissions and, where it is an element, his scienter. His employer, the brokerage firm, would be secondarily liable to the customer—without proof as to its own separate fault—for violations committed by its employee acting within the scope of his employment. Other persons who are not subject to respondeat superior liability but nevertheless control the primary wrongdoer could be held liable under Section 20(a) of the Securities Exchange Act or other relevant controlling-person provisions.[10] Because the liability of persons in this latter category represents an expansion of liability beyond that imposed by common law, they are afforded statutory defenses not available in an employer-employee context. Thus, controlling persons may avoid liability under Section 20(a) by demonstrating that they acted in "good

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[10] In contrast, in *Rochez Brothers* v. *Rhoades, supra,* 527 F.2d at 891, the court held that the corporation was not subject to Section 20(a) because it did not control its president who committed the fraud; rather, the president controlled the corporation and they "cannot simultaneously be 'controlling persons' as to each other." But see *SEC* v. *First Securities Co. of Chicago,* 463 F.2d 981, 987 (7th Cir.), cert. denied, 409 U.S. 880 (1972).

faith" within the meaning of that Section, *i.e.*, that their conduct was no worse than negligent. See *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 209 n.28.

Conversely, permitting controlling-persons who acted negligently to avoid liability under Section 20(a) is appropriate only if employers are subject to strict liability under respondeat superior. The public would have little protection if, for example, a broker-dealer could evade all responsibility to a customer for the fraud of the firm's salesman by demonstrating that it was merely negligent in failing to discover the wrongdoing. Under such circumstances, to permit an employer to assert the defenses contained in Section 20(a) would mean that the federal securities laws would provide *less* protection for defrauded persons than does common law or state law—surely an anomalous result that Congress did not intend in a statute designed to expand investor protection.[11]

4. Finally, petitioner incorrectly contends that imposition of respondeat superior liability is inconsistent with this Court's decision in *Ernst & Ernst* v. *Hochfelder*, *supra*, holding that scienter is a necessary element of violations of Section 10(b) as implemented by Rule 10b-5 (Pet. 11). In response

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[11] Nor does respondeat superior impose "insurer's" liability on the part of employers as petitioner suggests (Pet. 10). As one court has noted,

> [t]he familiar requirements of agency that the agent act within the course and scope of his employment and that he act within his actual or apparent authority serve to restrict the scope of the principal's liability.

Paul F. Newton & Co. v. *Texas Commerce Bank*, *supra*, 630 F.2d at 1119.

to an argument analogous to that of petitioner, in *United States* v. *A & P Trucking Co., supra,* 358 U.S. at 125, involving criminal charges, this Court characterized as "elementary" the proposition that "entities can be guilty of 'knowing' or 'willful' violations of regulatory statutes through the doctrine of *respondeat superior.*" As is implicit in this Court's decision in that case, the doctrine of respondeat superior does not undermine the elements of liability necessary to establish a violation, but merely serves to identify those persons who may be held vicariously liable for that violation.[12] With respect to a violation of Rule 10b-5, the culpability requirement, like all other elements, must therefore be satisfied by the state of mind or conduct of the primary wrongdoer as was the case here. The application of respondeat superior does no violence to the statutory scheme and is consistent with the settled principle that a corporation acts only through its employees and must bear responsibility for their acts. See *United States* v. *A & P Trucking Co., supra.*

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[12] See Margolis, *Sanctions Against Accountants for Violations of the Securities Laws: A Reappraisal,* 4 Del. J. Corp. L. 399, 418 (1979).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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